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The landlord's hypothec: difficulties in practice

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The authors argue that the reforms to the landlord's hypothec by the Bankruptcy and Diligence etc (Scotland) Act 2007 leave several questions unanswered and call on the Scottish Government to remedy the uncertainties.

On 1 April 2008 the landlord's hypothec was reformed fundamentally, when section 208 of the Bankruptcy and Diligence etc (Scotland) Act 2007 came into force. The headline changes were as follows. First, the enforcement procedure of sequestration for rent was abolished: s 208(1). Secondly, the hypothec no longer applies to leases of dwellinghouses, agricultural land or crofts: s 208(3). In effect its application is confined to commercial leases. Thirdly, the hypothec now cannot affect property which does not belong to the tenant: s 208(4). Significant law reform was therefore effected by means of one section in one Act. Unfortunately, the result is not a coherent one and the more that one looks at the provisions, the more questions which arise.

We understand that the uncertainties are causing significant difficulties for solicitors acting for both landlords and insolvency practitioners. This has been confirmed by the publication of two helpful articles focussing on the remedy in the insolvency context: R Roxburgh, "Landlord's hypothec in formal insolvencies" 2009 SLT (News) 227 and A Burrow, "Uncertain security" 2010 JLSS Jan/47. More recently, Professor Angus McAllister has published a compelling critique of some of the difficulties with the new law: see "The Landlord's Hypothec: Down But Is It Out?" 2010 Juridical Review 65. In this article, we too will highlight a number of problems now affecting the hypothec.

Enforcement: general

Now that sequestration for rent has gone, landlords need to know how to enforce the security. In practice we understand that some landlords are reluctant to do so because of the Taxes Management Act 1970 s 64(1), which makes them liable for certain tax arrears of the tenant. We return to this later. Section 208 of the 2007 Act in fact is

unacceptably opaque as to enforcement procedure. Subsection (2)(a) provides that the hypothec “continues . . . as a right in security over corporeal moveable property kept in or on the subjects let”. Subsection (2)(b) goes on to provide that it “ranks accordingly in any (i) sequestration; (ii) insolvency proceedings; or (iii) other process in which there is ranking, in respect of that property”. Exactly, however, is it to be enforced? In his article, at 2009 SLT (News) 227, Mr Roxburgh writes: “Currently there is no route for a landlord to enforce its hypothec rights other than through a formal insolvency process.” This may well be the view currently taken in practice. But it seems to run counter to the wording of s 208(2)(b)(iii), which refers to “other process in which there is ranking”. Surely this could include a competition between different unsecured creditors carrying out diligence, where there is no insolvency.

If this is correct, what enforcement procedure can be used? In a previous article entitled “Goodbye to Sequestration for Rent” 2006 SLT (News) 17, one of us pointed out that the answer may apparently be found in para 1019 of the Policy Memorandum to the Bill which has now become the 2007 Act. There, the Scottish Executive (as it was then called) stated in relation to the abolition of sequestration for rent: “The only defence [for sequestration for rent] would be that there was no alternative, but that is not the case as the landlord can attach any property of the debtor tenant under the 2002 Act.” If, however, attachment is to be the landlord’s means of enforcement now, s 208 should make that clear. Similarly, if the intention was that it can only be enforced now in insolvency, that should have been stated expressly.

Summary diligence

If attachment can be used this raises a number of issues. The first relates to manner of enforcement. In practice commercial leases invariably contain a clause under which the tenant consents to registration for preservation and execution in the Books of Council and Session. This enables the landlord to carry out summary diligence in respect of rent arrears and other sums due such as service charge. Can this type of diligence now be used to enforce the hypothec? If so, does the landlord have to say that this is what is being done and thus draw a distinction between the rent and other debts? This may be important if another creditor tries to carry out diligence and the landlord wishes to claim priority.

Equalisation of diligences

The second issue is whether an attachment used to enforce the hypothec is subject to the rules on equalisations of diligences. See the Bankruptcy (Scotland) Act 1985 s 37 and Sch 7 para 24, and the Insolvency Act 1986 s 185. The effect of these provisions is to remove the priority of a creditor who carries out diligence within certain periods of an insolvency. These did not apply to sequestration for rent, but do apply to attachment. What, however, is the position as regards an attachment used to enforce the hypothec? Arguably it is unaffected by the equalisation rules, because s 208(2), quoted above, provides that the hypothec ranks as a right in security. Conventional and tacit securities such as pledge and lien are not subject to the equalisation rules. Judicial security i.e. diligence generally is. Nevertheless, the position is not certain. Prof McAllister, for example, in his article, 2010 Juridical Review 65 at 69 takes the view that a landlord using attachment would have “no advantage over other creditors using the same method”. The lack of clarity in the law is problematic for practitioners trying to give advice to landlords and insolvency officials.

Enforcement in insolvency

The third issue is that in the past insolvency practitioners have not recognised the priority of the landlord under the hypothec unless there have been sequestration for rent proceedings. For example, in *Cumbernauld Development Corporation v Mustone* 1983 SLT (Sh Ct) 55 a receiver was appointed to the tenant company on 15 January 1981. On 27 February 1981 sequestration for rent was carried out. On 6 March 1981 a provisional liquidator was appointed, and then on 3 April 1981 the official liquidator took office. See similarly *Grampian Regional Council v Drill Stem (Inspection Services) Ltd* 1994 SCLR 36.

What in fact was the law prior to the 2007 Act? Mr Roxburgh refers in his article to W M Gloag and J M Irvine, *Law of Rights in Security* (1897) p 424: “A landlord, in virtue of his hypothec, has a real right over the *invecta et illata*, and is thereby preferable to the diligence of ordinary creditors, even without the use of sequestration. Thus he is entitled to stop a poinding, unless sufficient goods are left to satisfy his claim, or caution is found for the rent.” He continues “That would indicate that a landlord is entitled to a hypothec even without commencing any form of court action to establish it.” We would agree that the landlord is “entitled” to the hypothec.

However, being able to stop a poinding (in effect restraining other creditors) is not necessarily the same as directly enforcing the security. In fact, Gloag and Irvine go on to say: “And it is expressly provided in the Bankruptcy Act 1856 that nothing in the Act shall affect the landlord's hypothec; and therefore the sequestration of the tenant leaves the right of the landlord unaffected, and he may make good his right by sequestration under his hypothec in a question with the trustee”. They cite *Earl of Wemyss v Hewat* (1818) Hume 233, where a trustee in sequestration’s attempt to stop a sequestration for rent failed. The provision in the 1856 Act is now s 33(2) of the Bankruptcy (Scotland) Act 1985: “The vesting of a debtor’s estate in a trustee shall not affect the right of hypothec of a landlord”. Thus it appears that sequestration for rent was therefore still needed in a question with a trustee, because it was the way in which the hypothec was enforced. And, more generally, Gloag and Irvine write at p 430: “The general security afforded by the hypothec is converted into an attachment of specific subjects by the use of sequestration [for rent].”

Does attachment have to be carried out before the landlord’s security is recognised in practice under the new law? There is no explicit requirement under s 208(2), which we quoted above. It simply provides that the hypothec “continues . . . as a right in security” and “ranks accordingly in any - (i) sequestration . . .” It is difficult to argue that attachment is a pre-requisite of a claim given the word “continues” because it was not required before 1 April 2008. Rather, sequestration for rent was needed. It may therefore well be the case that the landlord is entitled to be preferred merely by making a relevant claim to the insolvency official. This is also the view taken by both Mr Roxburgh and Mr Burrow in their articles, but it is another defect of s 208 that it does not make the position absolutely clear.

Landlord’s liability for tax

A fourth issue leads on from the third. It concerns the Taxes Management Act 1970 s 64(1) (mentioned above). This provision has been amended by the 2007 Act Sch 6 Part 1 and earlier statutes. It now provides: “If at any time at which moveable goods and effects belonging to any person (in this section referred to as “the person in default”) are liable to be taken by virtue of any diligence whatever, or by assignation the person in default is in arrears in respect of any such sums as are referred to in subsection (1A) below, the goods and effects may not be taken unless on demand

made by the collector the person proceeding to take the goods and effects pays the such sums as have fallen due at or before the date of poinding or, as the case may be, other diligence or assignation.” Subsection (1A) sets out the relevant tax claims. The reference to “poinding” has been missed by the 2007 Act and indeed the Debt Arrangement and Attachment (Scotland) Act 2002 which replaced poindings with attachments. It should have been repealed. An earlier reference to this obsolete diligence along with one to sequestration for rent is duly repealed by Sch 6 Part 1. The important question, however, is whether s 64 applies if the tenant has become insolvent and the landlord simply intimates his or her right of hypothec to the insolvency official. The provision is predicated on there being a poinding or other diligence or assignation. In this situation there is no such process and therefore the provision does not appear to apply. This is the view taken by Mr Roxburgh, with which we agree. But it does take us back to the earlier question of the law requiring to be clarified in relation to enforcement.

The duty to plenish

It is well established at common law that in leases where the landlord’s hypothec applies the tenant is under a duty to plenish the premises with goods against which the security can be enforced if necessary. If this obligation is not fulfilled then the landlord can seek a plenishing order. Gloag and Irvine at p 428 write: “Such an order ordains the tenant to plenish the subjects, so as to afford security sufficient in value for the rent . . . It should be granted only for the rent covered by the hypothec, not for arrears of rent.” At common law, the hypothec had fairly restrictive time limits in this regard. Again in the words of Gloag and Irvine, this time at p 417, it gives “a right in security for each year’s rent as it falls due, provided that the goods have been actually on the premises during that year. It gives no security for arrears; and in order to make his right effectual, the landlord must enforce his hypothec by sequestration within three months after the term at which the rent is payable.” Exceptionally, sequestration in security for rent not yet due was permitted.

Section 208(8) replaces the common law rule by providing that the hypothec “(a) is security for rent due and unpaid only; and (b) subsists for so long as that rent remains unpaid.” The hypothec thus in principle covers far more rent, presumably up to five years arrears, at which point the short negative prescription will operate if there has

been no relevant claim. In practice no commercial landlord would let arrears build up that long. Nevertheless, what exactly is the effect of s 208(8) on the duty to plenish? Can the landlord now call on the tenant to plenish beyond the value of a year's rent? The position is simply unclear and should be clarified. For further discussion, see McAllister, 2010 Juridical Review 65 at 69-73.

Conclusion

The changes made to the landlord's hypothec unfortunately are not an example of good law reform. Too many uncertainties remain. The position may be contrasted with England. There the equivalent common law remedy of distress is to be replaced by a new procedure called Commercial Rent Arrears Recovery (CRAR). This will be regulated by the Tribunals, Courts and Enforcement Act 2007 ss 72-87 and Sch 12 and it is understood from the Ministry of Justice that the provisions will be brought into force in April 2012. We hope in the meantime that the Scottish Government will consider the difficulties arising out of s 208 of the Bankruptcy and Diligence etc (Scotland) Act 2007 and introduce appropriate amending legislation which clarifies the operation of the landlord's hypothec.

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